



U.S. House of Representatives
Committee on Transportation and Infrastructure

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September 21, 2007

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SUMMARY OF SUBJECT MATTER

TO: Members of the Committee on Transportation and Infrastructure

FROM: Committee on Transportation and Infrastructure Majority Staff

SUBJECT: Hearing on Rail Competition and Service

PURPOSE OF HEARING

The Committee on Transportation and Infrastructure is scheduled to meet on Tuesday, September 25, 2007, at 10:00 a.m., in 2167 Rayburn House Office Building to receive testimony on rail competition and service.

BACKGROUND

In the 1970s, the railroad industry was in poor financial health, suffering from rising costs, losses, and bankruptcies. Congress responded by passing the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980 ("Staggers Act"). Together, these pieces of legislation substantially deregulated the railroad industry. In particular, the Staggers Act gave the railroads substantial freedom to set rates, including the freedom to use differential ("Ramsey") pricing (which allows railroads to charge higher rates to captive shippers than shippers with competitive options), enter into contracts, and rationalize their physical infrastructure through the abandonment and spin-off to short lines of track and yards. At the same time, the Staggers Act gave the Interstate Commerce Commission ("ICC"), and later the Surface Transportation Board (STB or Board), the authority to establish a process so that shippers could obtain relief from unreasonably high rates. This process establishes a threshold for rate relief, allowing a rate to be challenged if it produces revenue equal to or greater than 180 percent of the variable cost of transporting a shipment.

Since passage of the Staggers Act, the freight railroad industry has become more concentrated. In 1976, there were 30 independent Class I railroad systems, consisting of 63 Class I railroads operating in the United States. Currently, there are seven Class I railroads in the United States: BNSF Railway; CSX Transportation; Grand Trunk Corporation, which consists of the U.S. operations of Canadian National (CN); Kansas City Southern (KCS); Norfolk Southern (NS); the former Soo Line, owned by Canadian Pacific Railway (CP); and Union Pacific (UP). Nearly half of the reductions since 1976 are attributable to mergers. According to the Association of American Railroads (AAR), in 2006, the seven Class I railroads controlled 87 percent of all ton-miles for the 562 railroads in the United States (1.776 trillion of 2.04 trillion ton-miles), which accounts for 40 percent of intercity freight ton-miles across all transportation modes (more than any other mode of transportation).

The reduction in the number of corporate entities since the Staggers Act has been matched by a decrease in the physical infrastructure of the railroads. In 1970, the Class I railroads operated about 206,000 route-miles of track. Today, abandonment and spin-offs to smaller railroads (which the Staggers Act authorized) have reduced this figure by 32 percent to about 140,810 miles. The contraction of the industry has been matched by a revival of its fortunes. In the 1970s, large portions of the rail industry were in financial and physical disrepair. Perhaps the prime example was in the Northeast, where the entire rail network (including the Penn Central and several smaller carriers) was bankrupt.

Today, most observers agree that the Staggers Act has been profoundly beneficial for the freight rail industry. A 2006 Government Accountability Office ("GAO") report examining the health of the freight railroad industry found that its financial health has improved substantially as railroads have cut costs by streamlining their workforces, right-sizing their rail networks, and reducing track miles, equipment, and facilities to more closely match demand. Freight railroads have also expanded their business into new markets—such as the intermodal market—and implemented new technologies, including larger cars. Over the past 10 years, the seven Class I railroads have reported progressively greater income, as shown below.

Railroads' Net Income (in \$ millions)

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996
BNSF	2,139	1,776	1,032	1,063	1,042	1,138	1,397	1,470	1,409	1,138	1,061
CSX	1,108	816	531	368	528	456	360	362	609	694	611
UP	1,819	1,279	929	1,422	1,521	1,397	1,319	1,306	399	883	1,009
NS	1,752	1,608	1,273	899	912	843	586	441	681	858	788
KCS	124	67	79	52	57	65	61	57	78	27	66
CN	525	447	309	220	136	67	55	86	-14	5	-22
CP	92	82	11	54	52	55	60	40	49	91	183
Total	7,559	6,075	4,164	4,078	4,248	3,610	3,838	3,762	3,211	3,696	3,696

Source: Association of American Railroads, Railroad Facts, 1996-2006

These gains for the railroads have come at a price for shippers. According to the GAO, in its recent report entitled *Updated Information on Rates and Other Industry Trends*, the railroads are shifting more costs to the shippers. For example, the GAO reports that a 20 percent shift has occurred in railcar ownership since 1987. In 1987, railcars owned by freight railroad companies moved 60

percent of tons carried. In 2005, they moved 40 percent of tons carried, meaning that the freight railroads' railcars no longer carry the majority of tonnage.

The GAO also found that in 2005, the amount of industry revenue reported as "miscellaneous" nearly tripled over 2004 levels, rising from about \$633 million to over \$1.7 billion. This miscellaneous revenue includes some fuel surcharges and other charges for providing rail service. In 2004, miscellaneous revenue accounted for 1.5 percent of freight revenue reported, while in 2005 it had risen to 3.7 percent. Also, in 2005, 20 percent of all tonnage moved in the United States generated miscellaneous revenue. While the STB in January 2007 adopted a rule stating it was unreasonable for freight railroads to compute fuel surcharges as a percentage of a shipper's base rate as well as applying a fuel surcharge, known as "double dipping," the STB has not finalized rules for railroads to report revenues raised from fuel surcharges. In May 2007, Dust Pro Inc. filed a class action lawsuit against BNSF, CSX, KCS, NS, and UP alleging that the railroads "moved in uniform lockstep" to fix prices for the fuel surcharges, which it said had no relationship to actual fuel costs. The case is pending.

Railroads have also been charging shippers, in particular captive shippers, higher rates. According to the GAO, while 2005 rates remain lower than 1985, they rose 7 percent over their 2004 levels. This represents the largest annual increase in rates during the 20-year period from 1985 through 2005, and outpaced increases in inflation – five percent in 2005.

While the GAO reports that the amount of captive traffic traveling at rates greater than 180 percent of the variable cost of transporting a shipment and the revenue generated from that traffic have both declined since 1985, the tonnage from traffic traveling at rates substantially over the threshold for rate relief has increased. Total industry tonnage has increased significantly (from 1.37 billion tons in 1985 to 2.14 billion tons in 2004), and the tonnage traveling at rates greater than 300 percent of the variable cost of transporting the shipment has more than doubled—from about 53 million tons in 1985 to over 130 million tons in 2004.

THE SURFACE TRANSPORTATION BOARD

The STB is the economic regulatory agency that Congress charged with the fundamental missions of resolving railroad rate and service disputes and reviewing proposed railroad mergers. The STB is decisionally independent, although it is administratively affiliated with the Department of Transportation. It was created in the Interstate Commerce Commission Termination Act of 1995 and is the successor agency to the Interstate Commerce Commission.

The STB serves as both an adjudicatory and a regulatory body. The agency has jurisdiction over railroad rate and service issues and rail restructuring transactions (mergers, line sales, line construction, and line abandonments); certain trucking company, moving van, and non-contiguous ocean shipping company rate matters; certain intercity passenger bus company structure, financial, and operational matters; and rates and services of certain pipelines not regulated by the Federal Energy Regulatory Commission.

The Board's adjudicatory decisions are appealable to the Federal courts. The court may overturn an STB decision (and remand the case to the STB) if the court finds that the Board's

decision was arbitrary, capricious or an abuse of discretion; was unconstitutional; exceeded the STB's statutory authority; failed to observe procedures required by law; or was unsupported by substantial evidence. The STB defends its own decisions against challenges in court and may appear in any civil action involving matters within its jurisdiction.

The Board is headed by three commissioners, which are appointed by the President and confirmed with the advice and consent of the United States Senate for five-year terms. The current commissioners are Chairman Charles D. "Chip" Nottingham, Vice Chairman W. Douglas Buttrey, and Commissioner Francis P. Mulvey.

Two important components of the current regulatory structure for the railroad industry are the concepts of revenue adequacy and demand-based differential pricing. Congress established the concept of revenue adequacy as an indicator of the financial health of the industry. The STB determines the revenue adequacy of a railroad by comparing the railroad's return on investment with the industry-wide cost of capital. For instance, if a railroad's return on investment is greater than the industry-wide cost of capital, the STB determines that railroad to be revenue adequate. Historically, the ICC and the STB have rarely found railroads to be revenue adequate, which many observers question given their sharp increase in revenues. Others, however, state that it is due to their cost structure. Railroads incur large fixed costs to build and operate networks that jointly serve many different shippers. Some fixed costs can be attributed to serving particular shippers, and some costs vary with particular movements, but other costs are not attributable to particular shippers or movements. Nonetheless, a railroad must recover these costs if the railroad is to continue to provide service over the long run.

Recently, the STB announced a proposed rulemaking to update its cost of capital methodology by updating how it computes the railroad's cost of equity. The cost of capital is integral in the Board's annual evaluations to determine the adequacy of the individual railroads' revenues each year, as well as in various types of regulatory proceedings. Under the proposed rule, the Board would use a Capital Asset Pricing Model (CAPM), rather than the discounted cash flow (DCF) method that it has applied since 1982. CAPM has become the private sector norm for measuring cost of equity and is also the measurement utilized by the Board's counterpart in Canada. The Board expects that CAPM will significantly reduce the railroad's reported cost of capital, as shown below in this comparison chart.

Cost-Of-Equity Comparison

Year	Current DCF	CAPM
1997	13.8	10.5
1998	13.1	8.8
1999	12.9	9.3
2000	13.9	9.3
2001	12.8	8.2
2002	12.6	7.3
2003	12.7	6.7
2004	13.2	7.1
2005	15.2	7.5

Source: STB

As a result, under the proposed rule, there is a greater likelihood that the majority of Class I railroads will be revenue adequate, which should lower the maximum rate a railroad may charge a captive shipper.

Demand-based differential pricing, in theory, permits a railroad to recover its joint and common costs—those costs that exist no matter how many shipments are transported, such as the cost of maintaining track—across its entire traffic base by setting higher rates for traffic with fewer transportation alternatives than for traffic with more alternatives. Differential pricing recognizes that some customers may use rail if rates are low, and if they have other options if rail rates are too high or service is poor. Therefore, rail rates on these shipments generally cover the directly attributable (variable) costs, plus a relatively low contribution to fixed costs.

In contrast, customers with little or no practical alternative to rail—“captive” shippers—generally pay a much larger portion of fixed costs. Moreover, even though a railroad might incur similar incremental costs while providing service to two different shippers that move similar volumes in similar car types traveling over similar distances, the railroad might charge the shippers different rates. Furthermore, if the railroad is able to offer lower rates to the shipper with more transportation alternatives, that shipper still pays some of the joint and common costs. By paying even a small part of total fixed cost, competitive traffic reduces the share of those costs that captive shippers would have to pay if the competitive traffic switched to truck or some other alternative. Consequently, while the shipper with fewer alternatives makes a greater contribution toward the railroad’s joint and common costs, the contribution is less than if the shipper with more alternatives did not ship via rail.

The Staggers Act further requires that the railroads’ need to obtain adequate revenues to be balanced with the rights of shippers to be free from, and to seek redress from, unreasonable rates. Railroads incur variable costs—that is, the costs of moving particular shipments—in providing service. The Staggers Act stated that any rate found to be below 180 percent of a railroad’s variable cost for a particular shipment is not unreasonable and authorized the ICC, and later the STB, to establish a rate relief process for shippers to challenge the reasonableness of a rate. The Board may consider a rate case only if the carrier has market dominance over the traffic at issue if: (1) the railroad’s revenue is equal to or above 180 percent of the railroad’s variable cost (R/VC); (2) the railroad does not face effective competition from other rail carriers or other modes of transportation; and (3) the rate is already in effect.

Where a railroad has market dominance over traffic, its rate for that traffic must be reasonable and the STB must determine the reasonableness of the rate if challenged. A shipper may seek both reparations and a prescribed rate by the STB of the maximum reasonable rate that the railroad may charge for future shipments. However, there is a limit to the rate relief that the STB can award, as it cannot require a railroad to lower a rate below the jurisdictional floor (180 percent of the R/VC ratio) and it cannot award reparations based on a rate below that level.

In assessing whether challenged rates are reasonable, the STB normally applies the Constrained Market Pricing (CMP) guidelines developed by the ICC in *Coal Rate Guidelines, Nationwide*, 1 ICC.2d 520 (1985), *aff’d sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987). Notwithstanding the title of the ICC’s decision, the CMP guidelines are not limited to coal rates, but apply to rates on all types of repetitive, high-volume traffic.

CMP imposes four constraints on a railroad's pricing of captive traffic that are applied by a shipper in making a rate case: (1) a captive shipper should not be required to pay more than is necessary for the railroad involved to earn adequate revenues (the revenue adequacy constraint); (2) a captive shipper should not pay more than is necessary for efficient railroad operation (the management efficiency constraint); (3) a captive shipper should not bear the costs of any facilities or services from which it derives no benefit (the stand-alone cost constraint); and (4) changes in the rate should not be so precipitous as to cause severe economic harm (the phasing constraint).

Rail shippers have generally preferred to use the Stand-Alone Cost (SAC) test in making rate disputes.¹ They find it easier and more effective to analyze a selected subset of rail operations than a large railroad's entire system, and to design an entirely new and optimally efficient system than to suggest improvements in conducting existing, potentially dated rail operations. Given the massive and detailed nature of the evidence needed in SAC cases, the Board has issued general guidelines for presenting evidence in SAC cases to standardize the format and focus the evidentiary presentations.

However, a CMP presentation can be expensive and not feasible for a shipper if the amount of money at issue is not large enough to justify that expense. Therefore, the STB has adopted simplified guidelines for use in those cases in which it finds that CMP cannot practicably be applied. The simplified rate guidelines use three average revenue-to-variable cost (R/VC) benchmarks, in combination, as a starting point for a more individualized case-by-case rate reasonable analysis.

While the simplified guidelines have been in place since 1997, a rate case has not been decided under the process set out by the guidelines. The STB held public hearings in April 2003 and July 2004 to examine why shippers have not used the guidelines and to explore ways to improve them. At these hearings, numerous organizations provided comments to the STB on measures that could clarify the simplified guidelines, but no action was taken. Shippers are concerned about using the simplified guidelines because they believe the guidelines will be challenged in court, resulting in lengthy litigation and further delaying rate relief.

In response, in September 2007, the STB issued new simplified rate guidelines. Pursuant to this process, freight rail customers can obtain an award of up to \$5 million in relief within 17 months of filing a complaint. The Board's decision allows freight rail customers to choose which rate dispute resolution process they would like to use. In an effort to minimize litigation, the Board will require mediation in all rail rate disputes. However, many shippers believe the new simplified guidelines are not an improvement over the old guidelines. For example, the 17-month deadline is one month longer than the STB's rules for large rate (SAC) cases (which call for a 16-month schedule). Additionally, shippers contend the simplified standards are unnecessarily complicated. Further, the shippers point out that the involved shipper participants uniformly opposed the rules as unworkable.

While the STB reports it has taken a number of actions to improve the rate relief process and assess competition, the GAO reported in 2006 that further actions are needed to address competition and captivity concerns. The Staggers Act and the ICC Termination Act encouraged competition as the preferred method to protect shippers from unreasonable rates and granted the

¹ The top-down (revenue adequacy) approach has been used in one pipeline case. See *CF Indus., Inc. v. Koch Pipeline Co.*, STB No. 41685 (May 9, 2000), *aff'd sub nom. CF Indus., Inc. v. STB*, 255 F.3d 816 (D.C. Cir. 2001) *reh'g denied* (D.C. Cir. Sept. 25, 2001).

STB broad legislative authority to monitor the performance of the railroad industry. However, the GAO reports that these processes have proven to be largely inaccessible because the standard process remains expensive, time consuming, and complex, and the simplified process has not been used.

The GAO also reported that there is widespread agreement that the STB's standard rate relief process is inaccessible to most shippers and does not provide for expeditious handling and resolution of complaints. The process is expensive, time consuming, and complex. The GAO found that the process can cost approximately \$3 million per litigant and that the dispute must involve more than several million dollars to make it worthwhile to spend \$3 million on a case that they could possibly lose, not including upwards of \$178,200 to file a rate case before the Board. Thus, only large volume shippers, such as coal shippers, with set origins and destinations have the money to be able to afford the STB rate relief process. Additionally, shippers report that they do not use the process because it takes so long for STB to reach a decision. Lastly, shippers continue to state that the process is both time consuming and difficult because it calls for them to develop a hypothetical competing railroad to show what the rate should be and to demonstrate that the existing rate is unreasonable. Since 2001, 11 CMP cases have been filed with the Board. All but one is a coal rate dispute. Of the 11, three have been settled and dismissed, one was withdrawn, and one is still pending. Of the six in which final decisions were issued (all using the SAC constraint), all were shipper losses. Further, the STB reports that the average processing time is 2.8 years, with the fastest case taking 1.8 years for a decision to be reached and the longest being over four years.

Finally, the STB offers an arbitration process to resolve disputes that has never been used. Under this approach, an arbitrator would decide the rate, using a "give and take" approach—that is, the arbitrator would determine the rate without being required to pick one of the two offers. The STB reports this option has not been used, in part, because the cases that go before STB are contentious, with high monetary stakes. As a result, there is less willingness from either side to arbitrate.

COMPETITIVE ACCESS ISSUES

Shipper groups, economists, and other experts in the rail industry have suggested remedies that could provide more competitive options to shippers in areas of inadequate competition or excessive market power. These groups view these approaches as more effective than the rate relief process in promoting a greater reliance on competition to protect shippers against unreasonable rates. Some proposals would require a reopening of past STB decisions or a legislative change. These include:

- *Reciprocal switching:* This approach would allow the STB to require railroads serving shippers that are close to another railroad to transport cars of a competing railroad for a fee if such an action would serve the public interest. The shippers would then have access to railroads that do not reach their facilities. This approach is similar to the mandatory inter-switching in Canada, which enables a shipper to request a second railroad's service if that second railroad is within approximately 18 miles. Some Class I railroads already interchange traffic using these agreements. This approach could also reduce the number of captive shippers by providing a competitive option to shippers with access to a proximate but previously

inaccessible railroad and thereby reduce traffic eligible for the rate relief process. This issue is addressed in H.R. 2125, the Railroad Competition and Service Improvement Act of 2007, sponsored by Chairman Oberstar and Ranking Republican Member Baker.

- *Terminal agreements:* This approach would allow one railroad to grant access to its terminal facilities or tracks to another railroad for a fee. Current regulations require a shipper to demonstrate anti-competitive conduct by a railroad before the STB will grant access to a terminal by a non-owning railroad unless there is an emergency or when a shipper can demonstrate poor service and a second railroad is willing and able to provide the service requested. However, shippers assert that proving anti-competitive conduct by a railroad is excessively onerous and, to date, no shipper has succeeded in proving that a terminal owning railroad has engaged in anti-competitive conduct. Granting access to terminal facilities or tracks for a fee would also make it easier for competing railroads to gain access to the terminal areas of other railroads and could increase competition between railroads. This issue is not addressed in H.R. 2125.
- *"Bottleneck" rates:* This approach would require a railroad to establish a rate, and thereby offer to provide service, for any two points on the railroad's system where traffic originates, terminates, or can be interchanged. Some shippers have more than one railroad that serves them at their origin and/or destination points, but have at least one portion of a rail movement for which no alternative rail route is available. This portion is referred to as the "bottleneck segment." The STB's decision that a railroad is not required to quote a rate for the bottleneck segment has been upheld in Federal court (See *Mid-American Energy Co. v. Surface Transportation Board*, 169 F. 3d 1099 (8th Cir.: Feb.10, 1999) and *Union Pacific Railroad v. Surface Transportation Board*, 202 F. 3d 337 (D.C. Cir.: 2000)). The STB requires a railroad to provide service for the bottleneck segment only if the shipper had prior arrangements or a contract for the remaining portion of the shipment route. The proposed alternative would give shippers access to a second railroad, even if the single railroad is the only railroad that served the shipper at its origin and/or destination points, and create more competition. This issue is addressed in H.R. 2125.
- *Paper barriers:* This approach would prevent, or limit, paper barriers, which are contractual agreements that can occur when a Class I railroad either sells or leases some of its track to other railroads (typically a short-line railroad and/or regional railroad). These agreements stipulate that virtually all traffic that originates on that line must interchange with the Class I railroad that originally sold or leased the tracks or pay a penalty. Since the 1980s, approximately 500 short lines have been created by Class I railroads selling a portion of their lines; however, the extent to which paper barriers are a standard practice is unknown because they are part of confidential contracts. These agreements prevent smaller railroads that connect with or cross two or more Class I rail systems from providing rail customers access to competitive service and prevent those smaller railroads from expanding service and earning more revenues. This issue is addressed in H.R. 2125.
- *Trackage rights:* This approach would require one railroad to grant access of its tracks to another railroad, enabling railroads to interchange traffic beyond terminal facilities for a fee. In the past, the STB has imposed conditions requiring that a merging railroad must grant

another railroad trackage rights to preserve competition when a merger would reduce a shipper's access to railroads from two to one. This issue is not addressed in H.R. 2125.

The STB has previously required railroads to adopt the actions listed above as a condition for approving mergers in order to maintain adequate competition. For instance, the STB granted the BNSF and other railroads trackage rights over about 4,000 miles of track as a condition to approve the 1996 merger of UP and the Southern Pacific. In the case of the breakup of Conrail in 1997, the two acquiring railroads, NS and CSX, share some of the lines and terminals of the former railroad.

Today, shippers assert that the improved financial health of the railroad industry warrants a reexamination of the goals of railroad policy as stated in the Staggers Act. They contend that existing interpretations of the statute are based on precedents established in an outdated era of excess rail capacity. With segments of the rail network now experiencing congestion, captive shippers argue that, as a matter of public policy, rail shippers should be given greater latitude to reroute their traffic to less capacity constrained routes. In contrast, the railroads maintain that the shippers' concerns about rail service would be resolved with increased infrastructure investment, which would expand capacity on the rail network. They also contend that shippers are paying outdated rates covered in long-term contracts that are now up for renewal and that those rates do not cover the railroads' transportation costs and investment needs. The Committee will receive testimony from both sides of this issue.

EXPECTED WITNESSES

Mr. W. Douglas Buttrey
Vice Chairman
Surface Transportation Board

Ms. Susan M. Diehl
Senior Vice President, Logistics & Supply Chain Management
Holcim, Inc.

Mr. Glenn English
Chief Executive Officer
National Rural Electric Cooperative Association

Mr. Ronald R. Harper
Chief Executive Officer and General Manager
Basin Electric Power Cooperative

Mr. JayEtta Z. Hecker
Director, Physical Infrastructure Issues
Government Accountability Office

Mr. Wayne Hurst
Vice President
Idaho Grain Producers Association
On behalf of the National Association of Wheat Growers

Mr. Terry Huval
Director
Lafayette Utilities Service
(Lafayette, Louisiana)

Mr. Kenneth C. Clayton
Associate Administrator, Agricultural Marketing Service
U.S. Department of Agriculture

Mr. Charlie N. Marshall
Senior Vice President of Industry Relations
Farmrail System, Inc.

Mr. Francis P. Mulvey
Board Member
Surface Transportation Board

Mr. Charles D. Nottingham
Chairman
Surface Transportation Board

Mr. William Rennie
Director
Oliver Wyman, Inc.

Mr. Gary Spitzer
Vice President and General Manager
Chemical Solutions Enterprise
DuPont

Mr. Jim Young
Chairman, President, and Chief Executive Officer
Union Pacific Railroad